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TAGS: ECON EFIN HK CH
SUBJECT: NEW RENMINBI PRICING MECHANISM MAY LEAD TO LARGER
DAY-TO-DAY RATE CHANGES

Classified By: EP CHIEF SIMON SCHUCHAT; REASONS: 1/4 (B/D)

SUMMARY

¶1. (C) Hong Kong-based financial strategists note that the recent change to how China sets the benchmark exchange rate for the renminbi (RMB) breaks the link between prices on consecutive days, allowing for potentially quicker and greater movements in the RMB/USD exchange rate. The new mechanism has created both the technical basis and face-saving cover needed for a more rapid upward appreciation of the RMB relative to the U.S. dollar (USD) should Chinese officials decide such a move is desirable. There are two scenarios where this appears potentially applicable. First, if the USD were to fall suddenly against other global currencies, China now has the means to let the RMB move upward quickly (i.e., retain its value against a broader currency basket) in response. Second, should China decide to respond to economic imbalances or political pressure from trade partners by engineering a sudden appreciation of its currency, the new system allows it do so without violating day-to-day price change limits that were previously in place. We have yet to hear predictions of dramatic short-term changes in store for the RMB, but three of the analysts whose comments we cover in this message do foresee RMB appreciation this year of 3-13 percent. END SUMMARY

MORE FLEXIBILITY

¶2. (U) On January 4, China changed the mechanism by which the daily RMB/USD exchange rate is established. Under the previous system, dating to the breaking of the RMB/USD peg in July 2005, the RMB value moved fractionally each day relative to its value against the USD at the close of the previous day. Pricing was in principle determined against an unrevealed basket of foreign currencies, but the scope of variances across days was still capped at /- 0.3 percent relative to the USD. (Note: The RMB, which now trades at approximately 8.07 to the USD, was revalued upward by 2.1 percent on July 21, 2005, and has since appreciated an additional 0.5 percent. End Note.)

¶3. (SBU) The significance of the new method of setting what is called the daily central parity rate involves breaking the link between rates on consecutive days. Fluctuations of the RMB/USD exchange rate within a trading day are still limited to /- 0.3 percent, but the connection between the closing rate on one day and opening rate on the following day has been eliminated. The central parity rate is now determined

independently each morning as follows: The China Foreign Exchange Trading System asks for prices from 13 banks (five of them foreign) known as "market makers," i.e., banks that are legally compelled to buy and sell according to their publicly quoted prices. The highest and lowest prices are thrown out and a computation is made according to an unrevealed weighted average of the remaining bids.

¶4. (U) Market observers believe the weightings are heavily geared towards China's "big four" banks, since those institutions account for the lion's share of RMB trading. Another feature of the new system is that banks can trade RMB over-the-counter (OTC), i.e., with each other. Most trading was previously conducted between the People's Bank of China (PBOC) and the respective banks. In the two weeks since the change to the pricing mechanism was announced, there has been no apparent impact on RMB trading behavior; the currency has traded between 8.065 and 8.07 to the USD. In the longer term, however, there are potential implications for broader renminbi revaluation, according to our contacts.

POTENTIAL IMPACT

¶5. (SBU) Breaking the link with the previous day's pricing has created a mechanism by which the PBOC can orchestrate significant changes in the RMB's value without being accused of determining rates in an arbitrary manner. DBS Bank Managing Director Andrew Fung suggested to us that if, for example, the USD tumbles overnight against the basket of currencies that now determines the RMB's value, the next day's central parity rate could then be fixed well above the previous day's close. Fung, whose bank projects a 3-4 percent appreciation for the RMB this year, believes the new

arrangement will yield a more flexible and market-determined crawling peg for the currency. (Comment: The USD has slipped a couple of percentage points against major Asian currencies so far this year, a trend that many forecasters expect to see continue. Since the RMB's value is in principle determined against a currency basket, the USD depreciation should theoretically make it easier for China to allow for a market-based appreciation of its currency. End Comment)

¶6. (C) Goldman Sachs Managing Director Hong Liang used the occasion of the January 12 visit of US Executive Director to the Asian Development Bank, Ambassador Paul Speltz, to comment on the change in the RMB value-setting mechanism. She said that the new methodology offers China a means to save face in responding to political pressure by creating a plausible way to move the currency's value quickly. In her view, the new method, by breaking the link between two given days of pricing -- at least in theory, she commented -- serves as a basis for a truly free float. The new flexibility is more significant than most observers realize, but much control still remains. Based on trading patterns that she is aware of, Liang believes the Bank of China's daily price offerings presently determine 70 to 90 percent of the value of the new exchange rate each day. In the future, however, RMB trading flows are likely to shift to other market makers, so there will less of a role for state banks in determining the central parity rate.

¶7. (C) Liang said that China is well aware that its recently released global trade figures showing a USD 102 billion surplus in 2005 underscore a need for RMB appreciation. She predicted that the surplus along with the recent 17 percent upward revision in GDP would increase calls by trading partners on China to allow its currency to appreciate, commenting that members of the U.S. Congress are likely to be particularly vocal. Liang cautioned that China would be particularly sensitive about appearing to cave in to foreign demands, especially with President Hu Jintao expected to visit the U.S. in the coming months. (Note: Goldman Sachs forecasts a 9 percent RMB appreciation over the next 12

months. End Note)

¶8. (SBU) Deutsche Bank Managing Director Jun Ma echoed Liang's views on the change to currency price-setting. In Ma's view, the modification of pricing methodology provides a technical basis for accelerated RMB appreciation, although the actual pace of the currency's movement will depend much more on domestic and international politics. JP Morgan Managing Director Grace Ng assessed the new mechanism as a more market-based "price finding" system for the determining daily changes in value. She views the change as a step beyond last July's break of the RMB/USD peg -- a move towards laying the groundwork for more RMB flexibility down the road. (Note: JP Morgan forecasts the RMB will appreciate 13% this year relative to the USD. End Note.)
Cunningham